

# PRE CONDITIONS OF INFLATION TARGETING

A Master's Thesis

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# **PRE CONDITIONS OF INFLATION TARGETING**

**Graduate School of Economics and Social  
Sciences  
of  
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MASTER OF ARTS**

**in**

**THE DEPARTMENT OF ECONOMICS  
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**ANKARA**

**DECEMBER 2011**

I certify that I have read this thesis and have found that it is fully adequate, in scope and in quality, as a thesis for the degree of Master of Arts in Economics.

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## **ABSTRACT**

### **PRE CONDITIONS OF INFLATION TARGETING**

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Inflation targeting regime is appeared as a new approach to achieve price stability objectives of the central banks. It is started be used at the beginnings of 1990's. Inflation targeting regime is based on an inflation target that is defined and announced to public. This regime has changed some structures of central banks. Central bank credibility became more important. Transparency came into prominence, therefore central banks started to give closer attention to communication strategies. This paper aims to define pre conditions of inflation targeting together with the history of Turkish economy to set light on the conditions that carry Central Bank of the Republic of Turkey to choose inflation targeting regime. After communication strategies are defined and communication strategies of different central banks are compared in this paper. As being one of the inflation targeting central bank, Central Bank of the Republic of Turkey is subjected to review and advices are given to improve its communication strategies to become more effective in applying inflation targeting regime.

Key words: Inflation targeting, communication strategies, interest rate projections,  
central bank transparency

## ÖZET

### ENFLASYON HEDEFLEMESİNİN ÖN KOŞULLARI

Başer, Şefika

MA, Ekonomi Bölümü

Danışman: Ass. Prof. Selin Sayek Böke

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Enflasyon hedeflemesi rejimi, merkez bankalarının fiyat istikrarı hedefine ulaşmakta kullandıkları yeni bir yöntem olarak 1990'ların başlarında ortaya çıkmıştır. Enflasyon hedeflemesi, enflasyon oranı için bir hedefin belirlenmesi ve kamuoyuna duyurulmasına dayanır. Bu rejim, merkez bankalarında bazı yapısal değişiklikler gerektirmiştir. Merkez bankası güvenilirliğinin önemi artmış, şeffaflık ön plana çıkmış, bu nedenle merkez bankaları iletişim stratejilerine daha fazla itina etmeye başlamışlardır. Bu makalede, enflasyon hedeflemesi rejiminin ön koşullarını tanımlanarak Türkiye ekonomisinin kısa geçmişi, Türkiye Cumhuriyet Merkez Bankasını enflasyon hedeflemesi rejimini uygulamaya yönlendiren koşullara ışık tutması açısından özetlenmiştir. Enflasyon hedeflemesi uygulayan merkez bankalarından biri olan Türkiye Cumhuriyet Merkez Bankası incelenmiş ve bu rejimin daha etkin şekilde uygulanabilmesi için iletişim stratejileri açısından tavsiyelerde bulunulmuştur.

Anahtar kelimeler: enflasyon hedeflemesi, iletişim stratejileri, faiz oranı tahminleri,  
merkez bankası şeffaflığı



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# **CHAPTER 1**

## **INTRODUCTION**

Starting from 1970's policy makers, central bankers and economists agree on the fact that price stability must be the long run objective of the monetary policy. To be able to achieve price stability, inflation targeting regime is started to be used in developed and also developing countries from the beginning of 1990's. To achieve and maintain price stability that is the final and prior objective of monetary policy for Inflation targeting regime, an inflation target (or target range) is defined by central bank and monetary policy is carried consistent with this target and the policies applied for this reason are shared with public and financial agents as part of transparency and communication procedures. In other words, inflation targeting regime means that making central bank's monetary policy to depend on a pre-defined numerical inflation target or target range.

The difference of inflation targeting from the other ways to control inflation is that monetary policy tools try to control future inflation instead of past or present inflation. Another difference is that inflation target is announced clearly to the public and central bank take direct responsibility about it.

There are mainly three pre conditions of inflation targeting. The first condition is monetary policy focus on price stability. Second one is central bank independence and third advanced financial markets. Monetary authority aims only to achieve defined inflation target. It means that objectives such as growth, employment level or exchange rate must not be chosen as a long run objective. To successfully apply the regime and keep inflation at the target level, effectiveness of the tools used by monetary authority depends on the advanced money, capital and exchange rate markets. Financial markets' not giving quickly responds to monetary policy tools results in deviations from the targeted inflation.

The objective of this paper is to discuss the properties of inflation targeting regime and examine the factors that affect Turkish economic authorities to apply inflation targeting. Moreover communication strategies are discussed and new approaches are subjected to review in order to find if they are appropriate or not to Turkish economy.

The first part of my work is the definition of inflation targeting. It is a brief review of literature. The basics of inflation targeting are given in this part. In addition historical facts that entail countries to start implementing inflation targeting are explained briefly.

In the second part, pre-requisites of inflation targeting regime are given. This part is separated to five sub-parts. These are central bank independence, transparency and credibility, having only one target, achieving fiscal discipline and finally having related and effective instruments.

The third part of the thesis is about economic history of Turkey before and after implementation of inflation targeting regime. History is studied in five periods.

1980-1989 period, 1989-1994 period, 1994-2002 period, 2002-2006 period and 2006-2011 period. Which factors affected Turkish economy and inflation rate and how monetary authorities replied to these factors are explained.

The next part is a comparison about the communication strategies of Central Bank of the Republic of Turkey (CBRT) with two other inflation targeting central banks. These are Central Bank of Norway (Norges Bank) (NB) and National Bank of Poland (NBP). The reason behind the selection of the two central banks is that Norges Bank represents an industrial country and NBP represents a developing country. Moreover, two central banks are also inflation targeters like CBRT. Two main differences between NB and CBRT are defined. These are press conferences and interest rate publications. CBRT is suggested to implement press conferences directly, but take some steps before implementing interest rate forecasts. Moreover, one difference is defined between the communication strategies of CBRT and NBP which is publishing the voting results of Monetary Policy Committee (MPC) meetings. CBRT is suggested to improve its transparency by means of publishing voting results of MPC meetings.

Although there are many paper written on the pre-conditions of inflation targeting regime in Turkey especially during the transition period, the studies on communication strategies is quite limited in Turkey. This thesis about “pre-conditions of inflation targeting; comparison of communication strategies” is desired to constitute a take-off to new studies and contribute to economical literature on this subject. Moreover it is aimed to light on the future decisions by evaluating the developments on communication strategies of different countries.

## **CHAPTER 2**

### **DEFINITION OF INFLATION TARGETING**

After the stagflation crisis of 1970's, inflation and unemployment problems became the prior objectives of monetary policies for world economy. Having been started to experience the two problems together although they were thought as the alternatives of each other, bring new questions about fighting against inflation for both economic theory and policy applications. The undesirable impacts of inflation on the economic growth and resource allocation are widely accepted among all economists. With the realization of even the moderate levels of inflation have bad effects on growth and economical activity; there is a consensus about price stability for being the necessary condition to achieve the other objectives of monetary policy (low unemployment and high growth rate). Duman (2002) says that "Manipulating the monetary policy instruments to attain other goals, such as output growth and employment, has the peril of an inflationary bias." (Duman, 2002) The definition of the desired price stability is given by former chairman of the Federal Reserve Bank Greenspan (2001) as: "Price stability obtains when economic agents no longer take account of the prospective change in the general price level in their economic decision making" (p. 1).

To obtain price stability countries try to reach low and stable inflation levels. Kadioğlu et al. (2000) mention about the importance of low and stable inflation for market-

driven growth and about the monetary policy's being the most direct tool for controlling inflation.

From the beginnings of 1970's both developed and developing countries choose monetary measures and exchange rate as nominal anchor and conduct their monetary policies by using these two variables. However, integrated national markets with globally liberalized capital movements and financial crises of 1990's have showed the disadvantages of monetary targeting and exchange rate targeting. The new approach "inflation targeting" started to take place of the old approaches for many developed and developing countries. The monetary strategy that is focused on price stability, helps policy makers to communicate about their intention on one hand, on the other hand creates discipline and accountability to central bank and government.

There are two main characteristics of inflation targeting that differentiate it from the other regimes. One of the characteristics is not having any other economic targets that are conflicting with inflation targeting. Second characteristic is trying to achieve a target that will be effective in future not today. Since future inflation is partly determined by today's expectations, central bank can only influence expected future inflation. Therefore, central banks alter the monetary conditions to influence expected inflation and bring the actual inflation in line with the targeted inflation rate. Besides, Duman (2002) states a superiority of inflation targeting as "contrary to exchange rate targeting, inflation targeting allows the central banks to



have greater discretionary power to respond to shocks of both domestic and foreign origin” (p. 3). In order to inflation targeting to be applicable an inflation target must be chosen that is not far away from the expectations and is possible to reach.

One of the most famous definitions of inflation targeting is given by Miskin. He enumerates five elements of inflation targeting:

1. A mid-term numerical target should be announced to public for future inflation.
2. The previous objective of central bank must be inflation; the other targets must have secondary importance.
3. When deciding which monetary policy should be used, not only monetary size or foreign exchange rates but also the other indicators must be followed.
4. Central bank should be in connection with public and markets about plans, aims and decisions of monetary authority by enlarged transparency of monetary policy.
5. More independence and more responsibility must be given to central bank to be able to reach the targeted inflation.

Although inflation targeting regime became popular for many countries, especially who experienced the disadvantages of exchange rate targeting and monetary measures in designing price stability, it is not very easy to successfully apply inflation targeting regime directly to every country. Inflation targeting regime has some pre-requisites to be applied successfully. Many developed countries have these pre-conditions already but some developing countries may not have these conditions. Next chapter describes the pre-requisites for inflation targeting regime.

## **CHAPTER 3**

### **PRE-CONDITIONS FOR INFLATION TARGETING REGIME**

Although inflation targeting regime seems desirable for achieving price stability, a country must have some pre-conditions to prosper with inflation targeting regime. Many research and papers can be found in the literature about the conditions of inflation targeting regime. In literature developed countries and developing countries are studied separately about their adaptation and success of inflation targeting regime, for example Batini and Laxton (Batini & Laxton, 2007); Fraga, Goldfajn and Minela (Arminio Fraga, 2003); Kara (Kara A. H., 2006); Kadioğlu, Özdemir and Yılmaz (Kadioğlu, Özdemir, & Yılmaz, 2000); Khan (Khan, 2003); Masson, Savastano and Sharma (Paul R. Masson, 1998); Mishkin (Mishkin, INFLATION TARGETING IN EMERGING MARKET COUNTRIES, 2000); Mishkin and Hebel (Frederic S. Mishkin, 2006); Özdemir (Özdemir, 2005) etc. studied developed and developing countries separately. Most of the researchers agree on the fact that, developed countries already have the necessary conditions, but a developing country must effectuate some reforms before starting inflation targeting. Duman (2002) asserts that “in order to implement inflation targeting effectively, an inflation targeting central bank must have a forward looking perspective, and must construct conditional inflation forecasts in order to decide upon the current instrument setting” (p. 4).

Although Batini et al. (2007) investigate if the pre-conditions are necessary to be successful in practice and find out the fact that none of the developing inflation targeters on their sample met pre-conditions suggests that failure to meet them is not by itself an impediment to the adoption and success of inflation targeting, it is worth to talk about the pre conditions of inflation targeting. This is because they conclude that “even if meeting institutional and technical standards may not be critical before inflation targeting is adopted, a proactive approach to making improvements by the central bank and other parts of government after adopting targeting may be essential to ensure the conditions needed for success.” (p. 27).

The most common pre-conditions of inflation targeting are; an independent central bank, achieving transparency and credibility, not having any other economic targets that are conflicting with inflation targeting, achieving fiscal discipline in line with the monetary policy’s movements towards the needs of inflation targeting, and having monetary policy instruments that are related with and effective on inflation targeting.

### **3.1. Central Bank Independence**

It is not wrong to say that the most important pre condition before starting inflation targeting is an independent central bank. Because central bank must be able to use its instruments to reach targeted inflation and achieve price stability without been exposed to the pressure of political authority. Batini (2007) says that “The central bank must have full legal autonomy and be free from fiscal and political pressure that create conflicts with the inflation objective” (Batini & Laxton, 2007). We can talk about central bank independence if central bank has the ability to control and

change monetary policy when necessary without being affected by political pressure. This does not mean that central bank is totally separated from government's general economic program. On the contrary, central bank should follow policies that are not conflicting with general economic program.

Central bank independence can be investigated under two parts, one is physical and legal independence and the second is instruments and objective independence. Legal independence is about the law of central bank that regularizes the relationship between the government and central bank. Appointment, deposition and term of office of central bank's governor, objectives of central bank, lending conditions of central bank to the public sector etc are regulated with the law of central bank. Central bank can be said to be independent as soon as it is not affected by any possible intervention by government or other public institutions. Having high public sector deficits because of government policies and financing these deficits by central bank resources is the leader of the problems that threatens price stability. A central bank that is able to say 'no' to inconvenient government policies is very important for adopting inflation targeting successfully. When there is a fiscal dominance and this result monetary policy to be designed for the financial needs of government, central bank's prior objective cannot be price stability and it gets harder to reach targeted inflation.

An independent central bank must be operationally independent. Operational independence means that central bank should be able to use all its instruments freely for reaching the targeted inflation. Instrument independence makes it necessary to have a stabilized and strong financial sector. To be able to reach targeted inflation, monetary policy must be dominant to fiscal policies. In other

words, fiscal policy must not be dictated its applications or limited monetary policy's affects.

### **3.2. Transparency and Credibility**

The success of monetary authority's program depends on the private sector's beliefs about monetary authority's attitude on tomorrow. In many inflation targeting countries, government included for defining inflation target. This assures that the government will support central bank to reach the target thus increases credibility of inflation targeting regime. Batini and Laxton (2007) says that "Inflation targets are intrinsically clearer and more easily observable and understandable than other targets, since they typically do not change over time and are controllable by monetary means" (Batini & Laxton, 2007). Without credibility, the program faces with time inconsistency problem. Since past and current inflation are already driven by the market and cannot be controlled, inflation targeting regime aims to control future inflation rate. In other words the main purpose of inflation target is to create a credible medium-term anchor for inflation expectations. Özdemir (2005) asserts that "provided that the Bank's explanations for deviations are credible, they need not damage the credibility of its monetary policy. The policies that are not credible in the eyes of private sector (create dynamic time inconsistency) are impossible to be successful" (p. 45).

The importance of transparency is to increase discipline, which also helps to increase credibility. Khan (2003) explains transparency as follows: "transparency implies the following: first, the explicit announcement of inflation targets, second, availability of clear and sufficient information to the public to assess the stance of

monetary policy, third, the announcement of any changes in monetary policy, a clear explanation of the reasons behind the changes, and the expected impact on the inflation outlook; fourth an ex-ante indication of a possible target breach, its causes and the policy actions that will be taken to bring inflation back on track; and finally, ex-post comprehensive analysis of the performance of monetary policy.” (p. 11). If the central bank cannot be transparent enough and the players on the market cannot reach information about the targets and the policies applied to reach the target, regime may lose its credibility in their eye. Therefore, transparency and credibility are considered together and must be satisfied together to be successfully implementing inflation targeting regime.

### **3.3. Having Only One Target**

Another important pre-condition of inflation targeting is monetary policy to aim only price stability not having other targets like foreign exchange rate, growth or unemployment rate. Otherwise, the policies applied for achieving monetary size or nominal variables may conflict with inflation targeting program. Fraga (2003) says that “One of the main advantages of an inflation targeting regime is the definition of a clear target for monetary policy. The existence of another target affects the credibility of the main goal of monetary policy” (Arminio Fraga, 2003). For these reasons, management of monetary policy should not orient to seniorage to compensate financial needs or to reach another nominal variable like foreign exchange rates. Since defining a target inflation rate adamantly puts a limit to inflation dynamics, it provides an environment to economic agents to build their

expectations without uncertainty and provides stabilization in expectations therefore makes it possible to reach the target.

Kadioğlu et al. (2000) point out another reason to why having one target is important for inflation targeting regime. They said that if there is another target, public may not believe that the inflation target has the priority, and they may set their expectations according to their beliefs. In their words “In that case, the public will make their own comments about the policy actions and there is no guarantee that the policy stance will give the exact signals about the actions and will cause true comments.” (p. 19) Therefore, having more than one target may destroy the credibility as well as the possibility of success of the regime.

### **3.4. Achieving Fiscal Discipline**

In the countries planning to start inflation targeting regime, having a strong financial and banking sector increases the possibility of success. Because, monetary instruments that are going to be used to reach inflation target, may drain banking system or failures happen in banking sector may make it difficult to reach the target. Fraga (2003) explains this problem as “In the case of fiscal and financial dominance, the problems that arise on the monetary policy front are quite similar: the fear that one or both regimes will break down will increase the probability that the government will inflate in the future, and therefore, increase expected inflation” (Arminio Fraga, 2003). For a successful monetary policy applied by central bank, the applied policies must be supported by fiscal policies. Otherwise, the effects of monetary policy may be counteracted by fiscal policies. Achieving fiscal discipline depends on achieving the following conditions:

- Not having fiscal dominance
- Not using central bank resources by public
- Having broad income by government so not depending on seniorage.
- Having deep financial markets that would be able to absorb public sector borrowing needs.

In order to successfully implement inflation targeting regime, a country should have the above conditions as well. Otherwise, country becomes fragile to fiscal oriented inflationist pressures. To prevent from conflicting behaviors of fiscal and monetary policies, inflation target should be defined together by government and central bank.

### **3.5. Having Related and Effective Instruments**

In order to execute how central bank's policy applications effects ultimate objectives like inflation, the changes in the monetary policy instruments' influence process of economy must be known. In other words, a stable relationship is needed between monetary policy and inflation in order to monetary policy to take inflation under control. An important point that ensures monetary policy's effectiveness is a well defined interaction mechanism. Tutar (2005) explains the relationship as; "inflation targeting requires an operational framework that will guide monetary authorities to conduct monetary policy. Under this framework, a comprehensive relationship is necessary between monetary policy and inflation and inflation must be predictable to a certain extent" (p. 19). Central bank chooses a monetary aggregate as a guide monetary policy instrument -such as short-term interest rates- to be able to control liquidity size of the financial system. The instrument in



question must be the tool that will serve the needs of monetary authorities perfectly.

After the crises in 2000 and 2001, inflation targeting started to be implemented in Turkey. Therefore, Turkey constitutes an appropriate example to explain which factors affected monetary authorities to choose inflation targeting and to show how the above mentioned pre-conditions were met.

## **CHAPTER 4**

### **HISTORY OF TURKISH ECONOMY**

Turkish economy experienced chronic high inflation since the beginnings of 1980's. Continuous high inflation not only affects economical activity badly but also creates social tension. Turkey's high inflation history can be divided into three periods. 1980-1989, 1989-1994, 1994-2002. After starting Implicit Inflation targeting in 2002, disinflation period took place of high inflation. CBRT started to apply formal inflation targeting regime in the beginning of 2006.

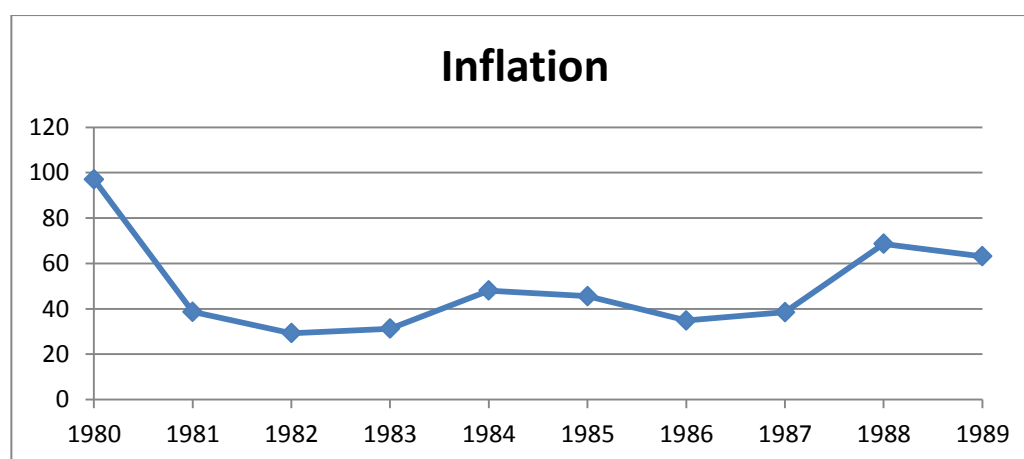
#### **4.1. 1980-1989 Period**

In 1980 Turkey started to use export oriented growth model and financial liberalization putted into effect. Starting from 1977, growing balance of payments deficits and debts of state economic enterprises lead to a foreign exchange financing crisis. Moreover expansionary monetary policy used because of wrong economical policies of the government. To be able to get rid of the bad effects of these factors, on 24 January 1980, Turkey started to apply a stabilization program supported by IMF. With this program to control inflation, tight monetary policy was used and domestic demand was tried to

be reduced by lowering prices. The first period of the program gave priority to the short-term objectives. The program had also included applications to enhance exports of goods and services. In line with this strategy, Turkish Lira (TL) was devaluated and manufacturing industry was encouraged to export with export incentives from the government.

Growth strategy used on this period mainly aimed at boosting productivity and improving competitive power of the economy. One of the most significant characteristics of this period was trying to keep the value of TL low to get advantage on export. But this strategy lessened the positive effects of stabilization program on inflation. The average inflation of Turkey was 97.09% in 1980, 38.65% in 1981, 29.27 in 1982, 31.23% in 1983, 48.01% in 1984, 45.54% in 1985, 34.85% in 1986, 38.50% in 1987, 68.60% in 1988 and 63.13% in 1989.<sup>1</sup>

**Figure 1- Inflation in Turkey (1980-1989)**



With the help of decreasing oil prices and increasing domestic demand in 1986, Turkish economy reached a growth rate more than expected. However, this growth was caused from the increase in public expenditures and resulted public sector

<sup>1</sup> The inflation rates are CPI's taken from <http://www.inflation.eu>

borrowing requirement to rise. Growing public deficits and increasing inflation caused unbalanced financial markets at the end of 1987. Consequently, tendency to exchange TL is strengthened.

On the other hand, starting from 1986, important changes happen in central banking in Turkey. Usta (2003) says that to be able to perform modern central banking functions, and apply monetary policies effectively within the scope of market mechanism, CBRT expedited corporate structural regularizations about the usage of indirect monetary policies in 1986 . For this reason, on April 1986 Interbank Monetary Market Department and on February 1987 Open Markets Department were established and CBRT started to govern financial markets.

Although inflation decreased and kept under 50% till 1987, monetization to finance export incentives and foreign debt burden and devolutionist foreign exchange policies resulted the inflation to jump above 60% in 1988 and 1989. On February 1988 some corrective measures were taken by CBRT. These measures were aiming to increase the demand on TL, restrain imports, boost exports, and reduce public spending. However, these measures could not assure the expected growth on the contrary carry the country into recession because of reducing investments on production.

## **4.2. 1989-1994 Period**

The most important development that assures monetary policy to be conducted healthily was a protocol signed between CBRT and Treasury on March 1989. The protocol brought discipline to use CBRT resources to finance public deficits. Another important economic development in 1989 was TL to become convertible and capital

movements to become liberalized. As a result of this development great amount of capital moved into Turkey and the reserves of CBRT increased. However, capital inflows weakened the control of CBRT on interests and exchange rates, which ended up with appreciated TL.

In 1990, CBRT prepared a monetary policy that targeting balance-sheet items. With the help of government's efficient financial policies, inflation rate decreased to 60.36%. In 1991 because of the effects of Gulf War, no monetary program could be applied and instead of obtain price stability, financial markets were tried to be stabilized. Although a monetary policy was declared in 1992, due to the facts that not been able to control budget deficits and financing an important part of these deficits through short-term advance from CBRT, the program could not be applied properly. In 1993, because of the continuing effects of Gulf War and public sector's borrowing requirement, a new monetary policy could not been declared. Especially between the period 1989-1993, as a result of uncontrolled budget deficits and financing these deficits by intense domestic borrowing, interest rates stayed high. Consequently, hot money flow into the country resulted TL to over valuate.

A growth period that depends on speculative gains caused a confidence crisis and carried the country to a financial crisis at the end of 1993. Although export rates stayed at the same level, import rates increased extremely so foreign trade deficit almost doubled. To sum up, Turkey faced drastic twin deficit on this period.

### **4.3. 1994-2002 Period**

During the second half of the 1990's the impact of high real interest rates became apparent. Further factors were growing budget deficits, foreign trade deficit and

incrementally increasing public debt especially domestic debt. High levels of real interest rates increased the borrowing requirements of the public sector. This created a debt-interest spiral and carried Turkey to a new financial crisis in 1994. Since the hot money in country outflow quickly, overnight interest rates went up to 1000%. Even though TL was devaluated 13.6% on 27 January 1994 foreign exchange reserves of CBRT decreased 4 billion US Dollar. Commercial banks increased their interest rates on deposits 15% and interest rates on 3-month treasury bills catch up 90%. Erosion of TL resulted in inflation rate to jump to 103.17%.

Just after the crisis a contractionary monetary policy program called January 24 decisions that aimed to decrease public borrowing and increase exports introduced. The main target of the stabilization program was increasing exports by decreasing public deficits. It was not only a short-term program that was applied to get over the impacts of crisis but also a long term economical turnover program. Cevik (2006) states that starting point of January 24 decisions is mainly slowing down inflation, achieving price stability and mitigating the effects of public sector on inflation. To finance this program government contracted a new stand-by agreement with IMF in 1995. However, because of the early general elections that took place on September 1995, the agreement was ruptured. Unfortunately, no stabilization program could be applied properly and lasted efficiently after 1994. Especially on the unsecure financial markets, the only growth source left was the high interested short-term foreign inflows. But after 1995 even the hot money flow could be achieved through very high real interest rates.

In conclusion, the main characteristics of 1990's can be enumerated as follows:

- Political instability

- Breakdown on the structural reforms
- High real interest rates
- Rapidly increasing debt
- Instable growth
- Fragile banking system

In this period focusing on price stability was hindered for CBRT by the fact that budget deficits could not be taken under control. CBRT gave priority to foreign exchange rates, interest rates and stability on financial markets to prevent from the risk of debt refunding. In this period of high interest rates and fluctuating inflation rate, tight monetary policies that are tried to be applied became ineffective, they even increased inflationist pressure.

Asian and Russian crises that aroused in 1997 and 1998 even worsen the situation. After 1998, reducing domestic demand, falling export to Russia, increasing atmosphere of insecurity on the financial markets, decreasing hot money inflows in spite of high interest rates and political uncertainties resulted in a new financial crisis. To overcome the crisis in December 1999 Turkey executed an IMF supported program that fights against inflation. An inflation target was set (20%) and the program used exchange rate as nominal anchor.

To settle increasing inflation and unsustainable debt, a stabilization program was applied in 2000. The primary objective of this program was reducing inflation permanently that used to be at two digit numbers about 25 years. With this program, it was intended to create a primary surplus through decreasing public expenditures and increasing revenues, public salary increases were proposed to be arranged with the inflation targeting rate and Structural reforms were specified

especially banking sector reform and privatization were planned to put into practice. Although the program was successful in some issues such as sharp decrease in interest rates, significantly slowed inflation and increasing production and domestic demand some factors canceled out the effects of the program. These factors were:

- over-appreciation of TL,
- rapid recovery in domestic demand,
- delays in planned actions for certain important structural reforms,
- political uncertainties,
- developments in the Euro/US Dollar parity.

As a result, Turkey faced September 2000 and February 2001 crises. Just after this program's failure Turkey's transition program was announced. Floating exchange rate regime was started to be used. The main objective of the program was restructuring the economy and achieving lasting stability and restoring confidence in the markets. The ultimate goal of the program was to achieve an increase in growth, investment and employment. On the introduction of the program CBRT (2000) states the objectives as:

"We aim to create an environment for sustainable growth, to increase the efficiency of resource utilization, and to develop our competitive strength through ensuring an open economy functioning under free market conditions. Our ultimate goal is to achieve an increase in growth, investment and employment that will instill confidence in our people for their future and lead to a permanent increase in their standard of living." (p. 14)



The most important improvement was the changed law of CBRT. New law (that is still in effect) states that the main objective of CBRT is to achieve price stability and gives instrument independence to CBRT for this reason.

#### **4.4. 2002-2006 Period**

On the CBRT's report "the monetary policy and exchange rate policy in 2002" inflation targeting concept was mentioned for the first time. In 2002, CBRT designed its monetary policy depending on two nominal anchors, monetary targeting and inflation targeting. The Governor of CBRT announced in his speech about monetary policy in 2002 that CBRT will focus on the "future inflation", in other words, CBRT started an "implicit inflation targeting" in 2002. It is also announced that, CBRT will switch to official inflation targeting when necessary conditions emerge later in the year. The program was aiming to bring down inflation to 12% within 3 years, and then to single digits.

With the help of the program that is put into process after the great depression in 2001 and that gave importance to financial discipline, Turkish economy recovered significantly.

Short-term interest rates were set as the main monetary policy instrument by CBRT in 2002. Although it is not announced targeted inflation was 35% and realized annual CPI was 26.42 for 2002. The same monetary policies continued in 2003 and 2004. While the inflation target was 20%, realized annual inflation rate was 17.04% for 2003. Similarly the target was 12%; the realized annual CPI was 8.97%.

In 2002 - 2004 period, both inflation slowed down and high growth rates were achieved. Since the targeted inflation rates were achieved to be realized, reliability

of inflation targeting regime was improved. Although fall in inflation rate slow down in 2005, it continued. The improvements about structural reforms, resolutely continuing middle term program, strengthening financial stability and other developments help New Turkish Lira to keep its strong position. CBRT started to reduce short-term interest rates as a monetary policy instrument.

Starting from January 2005, the Monetary Policy Committee (MPC) meets regularly under the chairmanship of the governor to discuss the developments in inflation and economy. Decisions on interest rates are announced taking into account the evaluations of the MPC meeting on the following business day. In the beginning of 2005, CBRT announced in its report “Monetary and Exchange Rate Policy in 2005” that formal inflation targeting will be launched at the beginning of 2006.

#### **4.5. 2006-2011 Period**

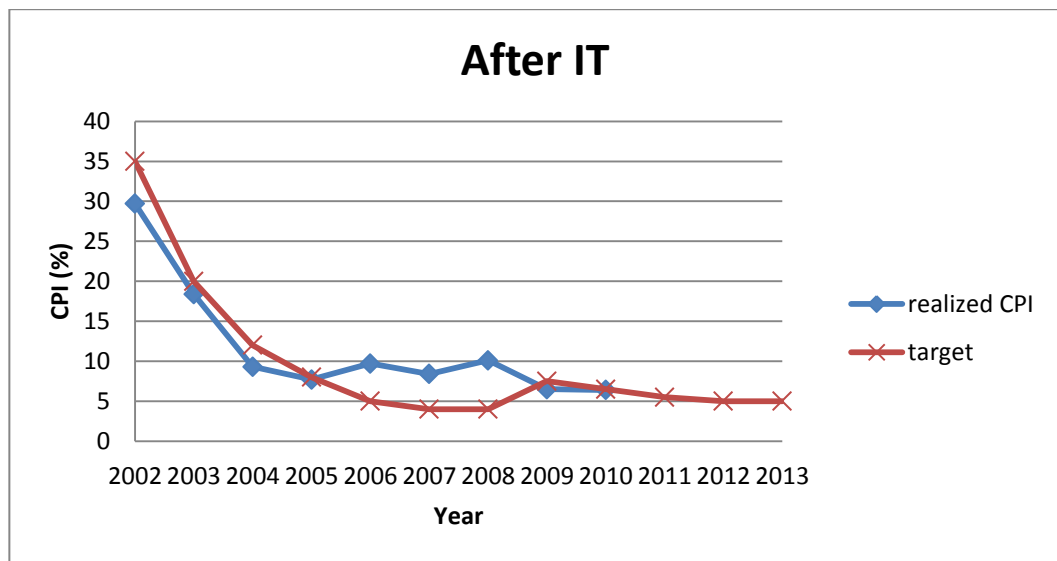
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>Target</b>	5,0	4,0	4,0	7,5	6,5	5,5	5,0	5,0
<b>Realized</b>	9,7	8,4	10,1	6,5	6,4	-	-	-

As a result of monetary and fiscal policies applied together with a harmonious and decisive manner, inflation fall to the single digit levels in company with high growth rates. The rapid growth starting from 2002 is continued in 2006 and 2007. The fluctuations on the financial markets on may and June 2006 caused YTL to depreciate and interest rates to increase on the second half of 2006. These events became the source of the deceleration in the growth rate. With the help of keeping

fiscal discipline pertinaciously and structural reforms on the public sector affected price dynamics positively.

The negative effects of global crises arise from USA mortgage crises are felt in the economical activities in 2008. Fiscal measures taken against crises caused public expenditures to increase and narrowing domestic economical activity caused tax revenues to decrease. In 2009, CBRT started to apply policies that will limit the negative effects of the crises on economic stability provided that they will not conflicting with price stability target. Since the negative effects of crises started to disappear in 2010, CBRT announced its new policy as a series of new precautions that are aiming to increase the efficiency of monetary policy and limiting the macro financial risks. In November 2010 CBRT started to apply a new monetary policy that is a composition of some monetary policy tools such as interest corridor and required reserves. Başçı (2011) explains the main difference between this new policy from the previous one as, as well as price stability, financial stability is also look out for and for this reason besides weekly repo tender interests, required reserves and active liquidity management are used as supportive policy instruments. To prevent from breaking down the inflation expectations because of the differentiation of objective function, CBRT maintain an active communication strategy.

**Figure 2- Inflation in Turkey (2002-2011)**



## **CHAPTER 5**

### **DISCUSSION**

As we mention earlier, transparency has great importance in inflation targeting regime. Depending on transparency, communication strategies of central bank gain importance, Mishkin says that “Transparency and communication, especially when it demonstrates the success in achieving a pre-announced and well-defined inflation target, has also helped build public support for a central bank's independence and for its policies” (Mishkin, 2004) In this part of the thesis communication strategies of CBRT will be compared with other two inflation targeting countries, both of which are industrial countries, namely Central Bank of Norway (Norges Bank) (NB), and National Bank of Poland (NBP). We will try to see the similarities and the differences between the three central bank's strategies. We will focus on the interest rate projections and the press conferences that NB applies but CBRT not. Another important focus is publishing the MPC voting results which is the major difference between the NBP and CBRT. We will try to discuss the difference between the strategies of central banks. Moreover we will try to find out if CBRT should be more transparent by publishing projections of

future interest rates and/or holding press conferences and/or publishing MPC voting results like NB, NBP and some other central banks doing.

## **5.1. Communication Strategies of CBRT**

CBRT announced in its publication about monetary policy for 2002 that the final target of monetary policy was the adoption of inflation targeting regime, but as the reliability of the regime would suffer in case this adoption was made prematurely; without satisfying the necessary pre-conditions. It was also pointed out in the same announcement that “implicit inflation targeting” would be implemented until the adoption of the inflation targeting regime. Between the periods 2001-2005, considerable progress was made in the formation of a suitable environment for the transition to an inflation targeting regime. CBRT chose “point target” as inflation target since it is easily understandable and it has advantages about communication and it announces a target policy for three years. Moreover, it is decided to define inflation target as consumer price index (CPI) because it can be viewed by everyone and it measures daily life expenditures well. However, since CPI is a comprehensive index, inflation may show deviations arise from the factors that are outside the control of monetary policy.

Furthermore, very significant steps were taken about the communication strategies of CBRT as a part of transparency. CBRT extended its communication tools. Regular communication tools of CBRT are:

- Inflation report
- Monthly policy statement

Moreover, CBRT publishes many reports in part of the communication strategy.

These reports are:

- Monthly price developments
- Independent audit reports
- Financial stability report
- Balance of payments report
- Monetary policy reports
- CBRT bulletin
- Quarterly bulletin
- Annual reports

Like many other inflating targeting central bank CBRT uses short-term interest rates as the key policy instrument to reach the targeted inflation. During the implicit inflation targeting period CBRT took some measures to make monetary policy more institutionalized. For example, monetary policy committee (MPC) meetings are done on the date that is defined and announced to public earlier. And the decision of interest rates is announced the business day after these meetings at 9:00am. After the announcement of the decisions a text is published including the views of the committee members also the reason for the decision. These texts not only give the reason of the decision but also give signals about the future decisions. Fraga (2003) states that “the timely publication of the detailed minutes of MPC meetings is a key ingredient for an effective communications strategy. In emerging economies, where credibility is typically lower than one would like, the benefits of publishing this information can be substantial” (Arminio Fraga, 2003).

## 5.2. Communication Strategies of NB

Norges Bank is also an inflation targeting central bank. The bank's aim is to promote economic stability in Norway. The objectives are enumerated as price stability, financial stability and added value in investment management on their web site. With the Government regulation of 29 March 2001, NB implemented inflation targeting regime starting from a target inflation rate 2.5 per cent for 2001. NB publishes the inflation report three times a year which provides an analysis of the outlook for the Norwegian economy and of developments in price and cost inflation two years ahead. The bank announces the dates of MPC meetings. The executive board discusses interest rate settings and other changes in the use of monetary policy instruments. The decisions of executive board are announced immediately after the meetings. Besides, the factors under the decisions are announced on a press conference by the Governor or a deputy Governor of the NB.

Norges Bank publishes monetary policy report three times a year. On the web site of NB it is explained as "the report assesses the interest rate outlook and includes projections for developments in the Norwegian economy, discussion of specific topics and a summary of Norges Bank's regional network reports".

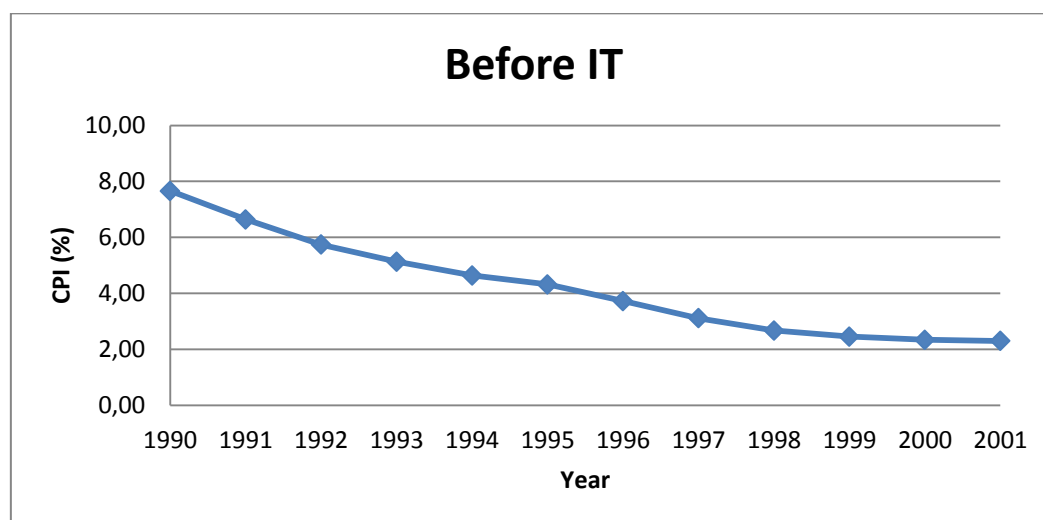
The realized CPI's<sup>2</sup> in Norway before and after implementing inflation targeting are given below tables. Norway had already experiencing a disinflationary period before starting inflation targeting regime. NB fixed target inflation at 2.5% but the realized inflation rate was always lower than the target.

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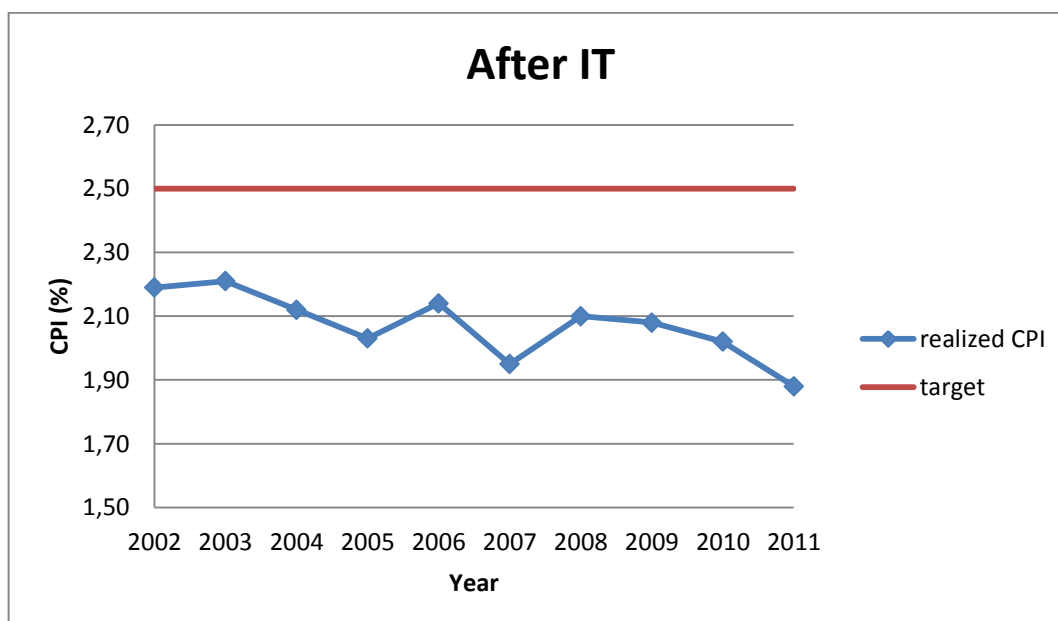
<sup>2</sup> CPI's are taken from the web site of Norges Bank (<http://www.norges-bank.no/en/>)



**Figure 3- Inflation in Norway (1990-2001)**



**Figure 4- Inflation in Norway (2002-2011)**



Norges bank publishes figures on key policy rate, Norwegian Interbank offered rate (NIBOR), treasury bills, and government bonds. The key policy rate (sight deposit rate) is Norges Bank's most important monetary policy instrument. They announce nominal and effective NIBOR rate on daily, monthly and yearly bases. Likewise, they

announce treasury bills and government bonds rates on daily, monthly and yearly bases. The main criteria that they give weight while preparing their interest rate forecast are given in their web site as follows:

- The interest rate should be set with a view to stabilizing inflation at target or bringing it back to target after a deviation has occurred.
- Interest rate developments should at the same time be able to provide a reasonable balance between the path for inflation and the path for overall capacity utilization in the economy.

They also find the following additional criteria useful because of the potential effects of asset prices on stability in output, employment and inflation:

- The interest rate should normally be altered gradually and in line with the Bank's previous response pattern.
- Interest rate developments should result in acceptable developments in inflation and output also under alternative assumptions concerning the economic situation and the functioning of the economy. It should be possible to explain any substantial and systematic deviations from simple, robust monetary policy rules (Gjedrem, 2010).

### **5.3. Communication Strategies of National Bank of Poland**

National Bank of Poland is an inflation targeting central bank since 1999. Within the framework of this strategy, the Monetary Policy Council defines the inflation target and then adjusts the NBP basic interest rates in order to maximize the probability of

achieving the target. The set of monetary policy instruments used by the NBP enables it to determine interest rates on the market. These instruments include open market operations, reserve requirements and credit-deposit operations. Like Norges Bank, NBP has a fixed inflation target at 2.5% since 2004, but unlike Norges Bank NBP has also a fluctuation band of +/- 1 percentage point. NBP publishes the following reports about their monetary policy:

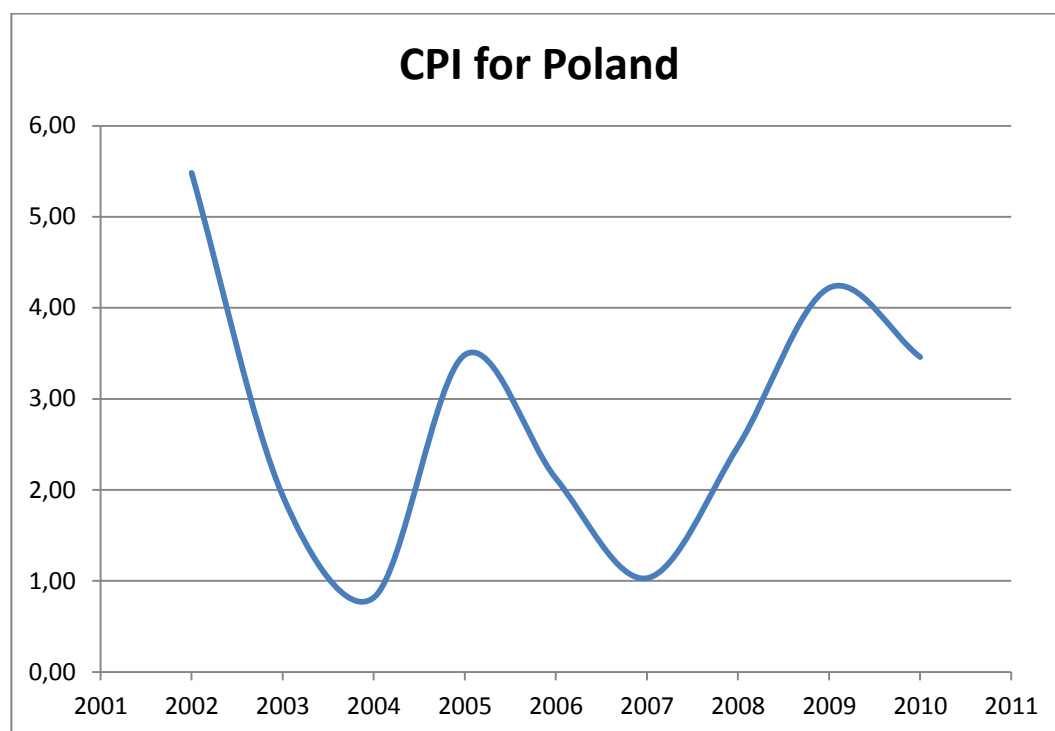
- Inflation Report
- Monetary Policy Guidelines
- Report on Monetary Policy Implementation
- Monetary Policy Strategy beyond 2003
- Medium-Term Monetary Policy Strategy, 1999-2003

NBP also publishes Information Bulletins on a monthly basis which includes information about overall economic and financial performance in Poland and on the policies of the central bank.

After MPC meetings NBP publishes press releases. Starting from April 2011, the National Bank of Poland is publishing the motions on its website relating to interest rates, together with a breakdown of votes cast by individual MPC members.

The realized CPI's for Poland are given in NBP's web site as follows:

**Figure 5- Inflation in Poland (2001-2011)**



After implementing inflation targeting regime, Poland had a very volatile inflation rate.

## **5.4. Comparison**

Communication with the public is a part of the monetary policy of central banks. Since one of the most important pre-requisites of successfully implementing inflation targeting is transparency, inflation targeting central banks gives special importance to their communication strategies. Tutar 2002 says that “The inflation target provides full transparency in the implementation of monetary policy that enables financial institutions in the market to foresee the future with less uncertainty and behave accordingly” (Tutar, 2002). Monetary policy reports and inflation reports are very important communication tools of central banks. Inflation targeting central

banks publishes reports about their monetary policies to give clues to the market and provide credibility. Monetary policy reports are important for the participants of financial markets because they include the information about whether there will be changes in the monetary policy on the next term or not. Inflation reports are published to summarize the conditions that affect inflation. The reasons of deviations from the target –if any- are explained in these reports. Central banks account for the realized inflation in front of public and governments because they are responsible to assure the inflation to be in line with the pre-announced target.

#### **5.4.1. Press Conferences: an Important Transparency Tool**

Financial markets follow the MPC decisions closely. The interest rate decisions taken on the MPC meetings are very important for the participants. Therefore, central banks announce their decisions to provide the necessary information to the markets as soon as possible. One of the three central banks (CBRT, NBP and NB) of interest on this paper, namely Norges Bank announces their MPC decisions by means of press conferences after the meetings. On the other hand CBRT and NBP publish a press release after the meeting, not hold a press conference about the meeting. Press conference provides more transparency, because central bank does not answer questions from the press by a press release. Norwegian press members have the opportunity to ask questions about the decisions of the committee on the press conference. CBRT can improve its transparency by starting to hold press conferences. A press conference provides an interrelation between the central bank and the public. Reports are important tools however no matter how detailed the reports are, they may not answer all the questions in minds. Having regular press

conferences not only improves transparency but also improves credibility indirectly. Therefore, CBRT is suggested to hold regular press conferences after the MPC meetings to improve its communication skills.

#### **5.4.2. MPC Voting Results**

Central Bank of Poland started to publish voting results of MPC meeting early this year (2011). This communication strategy is not applied by CBRT. Publishing voting results of MPC meetings is a way to increase transparency. In inflation targeting regime, central banks try to be more transparent to increase the credibility of the regime. This strategy is not requires so much preliminary preparations because it is easy to apply and is not includes risks. Therefore to become more transparent and improve the applied regime CBRT is suggested to publish voting results of MPC meetings.

#### **5.4.3. Interest Rate Forecasts: a Major Difference**

The main difference between NB and CBRT appears about interest rate forecast. NB publishes key interest rate forecasts and defines these forecasts as their most important monetary policy instruments. They give different weights to different criteria and define a loss function including these criteria. Gjerdem (2010) asserts that “The interest rate forecast is an expression of a balance between various monetary policy considerations and a response pattern that households, firms and financial institutions can build on. The interest rate forecast is based on our understanding of the functioning of the economy” (p. 1). Not surprisingly, there may be differences in projections for inflation and economic activity in one report

to another. Therefore, the forecasts for interest rates may also change. NB tries to exemplify the factors that affect the changes in the interest rate forecast through their effects on the prospects for inflation, output and employment. The forecasts have shifted considerably over time. This reflects that the interest rate is an instrument that should react to all news that may influence the inflation outlook.

On the other hand, while sharing predictions of inflation by means of inflation reports, CBRT explains qualitatively how policy interest rate will process but not publishes quantitative forecasts. Moreover, as discussed in the “history of Turkey” section, CBRT have been applying a new policy combination since November 2010. After starting the new policy, instead of giving tangible knowledge about interest rate policy, CBRT prefers to communicate on policy combination and “monetary tightening”. To give a more specific perspective about the size of the monetary tightening, a numerical range is articulated in the inflation report.

Researchers and central bankers are arguing whether more transparent central banks are beneficial or harmful for achieving targets. Only a few central banks are publishing their projections about future interest rates so far. More specifically they give not only comments about their future path of interest rate policy but also numerical forecasts. A study about the value of greater transparency by Rudebusch et al. (2008) shows that, under reasonable conditions, publication of interest rate projections better aligns the expectations of the public as a result central bank better meets its macroeconomic goals.

#### 5.4.4. Is Turkish Economy Ready for Projections?

Most central banks with direct inflation targets are communicating their inflation and output forecasts to the public. Some banks have gone one step further by showing their expected future path of interest rates. A comparison of the methods applied by central banks in preparing and releasing their forecasts indicates that in many areas there are no unique solutions. Moreover, the profession is still far from consensus as regards macroeconomic effects of forecasts publication. What we need to argue is that if publishing interest rate forecasts strategy is suitable for Turkish economy. It does not seem suitable because unlike Norwegian economy, Turkish economy is an emerging market economy. Being a small open economy, Turkish economy is vulnerable to shocks. Central bank should be able to use currently available information about future shocks –which is not always possible– in order to meaningfully discuss forecasts of future interest rates.

In contrast to the results of Rubus et al. (2008), Wyplosz et al. (2008) showed that dominance of transparency depends on the conditions of economy. They analytically test it and find that the parameters matter, being more transparent is not always more advantageous. They describe the economy with the standard New-Keynesian log-linear model including a Philips curve:

$$\pi_t = RE_t^p \pi_{t+1} + k_1 y_t + e_t$$

In this equation,  $E^p$  shows the expectations and  $\pi_t$  shows the realized inflation rate, also  $y_t$  is the output gap and  $e_t$  is a random disturbance uniformly distributed over the real line, with an improper distribution and a zero unconditional mean. Without loss of generality, they assume a zero rate of time preference so that  $R=1$ .



They found that current inflation depends on current and expected shocks and on current and expected policy interest rates. This implies that the central bank must take into account the effect of its current and future decisions on market expectations. They found that the welfare loss under full transparency is:

$$\beta L_t^{transparency} = \frac{1}{kz(1+z)} + \frac{1}{z+k}$$

They denote the relative precision of the central bank and the private sector signals as  $z = \frac{\alpha}{\beta}$  and assume that  $0 \leq k \leq 1$  and the parameter  $k$  measures the relative precision of early signals vis a vis the updated signals. According to their analyses, comparing transparency (publishing interest rate forecasts) and opacity (not publishing future interest rate forecast) in terms of welfare, parameters may change the result. They conclude that transparency dominates when  $z$  is large and when  $k$  is large. “The role of  $k$  is ambiguous: when  $k$  is small, an increase in  $k$  favors opacity while it favors transparency when  $k$  is large” (p. 15).

A similar study is done by the same authors in 2008 and they analyze welfare in this second study. To compare the two regimes (transparency and opacity) they looked at the difference between welfare functions calculated for the two regimes.  $\Delta L = L^{op} - L^{tr}$  They compared the welfare losses separately period by period. They found that “the transparency is always welfare increasing in period 2” (p. 22). The second result of the paper states that if the central bank signal  $\alpha$  is more precise than the private sector signal  $\beta$  then it is more likely that transparency pays off. Conversely, if the central bank signal is poor quality it can not be said exactly that transparency is better.

In order to be sure that if implementing this strategy to Turkish economy is beneficial or not, we should know how these parameters behave in Turkish economy. CBRT's signal about private sector expectations are comes from the "survey of expectations" that CBRT conducts twice a month, in the first and third weeks of every month. CBRT explains in information note on survey of expectations that the sample size is small since the participation is voluntarily. CBRT treats individual responses as strictly confidential in conducting this survey. The first part of the survey is "expectation of consumer price index" which is composed of five subparts. Expected CPI for the current month, expected CPI for the next month, expected CPI for the second month ahead, expected annual CPI by the end of the year, expected annual CPI by the end of the next 12 months and expected annual CPI by the end of the next 24 months are estimated throughout this survey. CBRT's signal  $\alpha$  is coming from this first part of survey of expectations. Although very important steps are taken to increase the reliability of the survey, such as revision of the questions and the improvements of the economical conditions that affect the expectations of the public, central bank signal can be said to be poor quality in comparison with an industrialized country.

Furthermore, Kara et al. (2005) studied about the rationality of inflation expectations in Turkey. They ask the question whether they are forward looking or backward looking. In other words they tried to answer whether inflation expectations provide an unbiased predictor of future inflation, and/or whether they are formed by making efficient use of all available information in the economy. They tested unbiasedness and efficiency separately to infer about the rationality of Turkish inflation expectations. They found that all the expectation series are biased

and inefficient, therefore not rational. Therefore, central bank signal  $\alpha$  is proved to be poor in Turkey by this paper which implies that transparency causes greater welfare loss in Turkey comparing to the opacity according to the results of Wyplosz et al. (2008).

Another disadvantage of publishing interest rate forecasts is its complication. Mishkin (2004) states that if the increase in transparency violates the KISS (Keep It Simple Stupid) principle, than it might not help the Central Bank to do its job and focus on the long run objective. Projection of policy rate path is understandable by economists but not all the participants on the market are economists, public may be confused about the policy of central bank. Interpreting the projections is important because a misunderstanding about the future policy may result in wrong decisions about the future economic activities. Moreover, if the misunderstanding becomes widespread, it may affect the whole economy and even result in moving away from the targeted inflation.

Publishing interest rate forecasts and becoming too transparent may harm CBRT's credibility. The reason is as follows. There are a lot of factors that affect the forecasts of future interest rates. In case of one of the factors have a change the forecast may need to be changed. Publishing a change in the previous policy announcement, public may confuse and view it as a mistake of central bank. It may destroy central bank's credibility in public's eyes. Because credibility is a concept that is hard to gain and sustain but is easy to lose.

Under these conditions suggesting to become more transparent to CBRT would not be a creditworthy suggestion. However, in light of the studies done on this subject, publishing interest rate forecasts seem to be the next step to be taken to become

more transparent. Being more transparent under the right conditions results in increasing credibility of the regime and therefore increasing the possibility of the success of the regime. What we can suggest to CBRT is to mature its conditions and then take the step of publishing future interest rate forecasts in the near future.

## **CHAPTER 6**

### **CONCLUSION**

By the end of 1980's harmful effects of high and volatile inflation are proved both by academic researches and by practical experiences. Having realized this fact achieving price stability became the most important issue for central banks and politicians. In 1990 New Zealand introduced a new approach to achieve and maintain price stability -inflation targeting approach. Since then researchers and policy makers made efforts to find the optimal way of performing this regime. Pre-conditions are defined to successfully implement inflation targeting.

In this study, necessary conditions of inflation targeting are studied. History of Turkish economy is explained and the conditions that carry Turkey to apply inflation targeting regime are discussed. Turkish economy went through very severe economic crises, tried many economic programs to recover, applied different monetary policies to achieve financial stability. Finally, Central Bank of the Republic of Turkey chose inflation targeting regime in 2001. During 2001-2006 period, CBRT implemented implicit inflation targeting regime while trying to accommodate pre-conditions of inflation targeting.

Central bank independence was provided first of all by its new law. By the support of the government, all the pre-conditions were tried to be met. Eventually, in 2006 Turkey started formal inflation targeting and continues with this strategy to achieve price stability.

In this study, communication strategies of CBRT are compared with communication strategies of NBP and NB. The main difference between the CBRT and NB is defined as the projections of future interest rates. This strategy is defined and discussed if it is a suitable strategy for CBRT or not. In conclusion, it is stated that the Turkish economy is not ready for publishing interest rate forecast because of some immature market conditions. It is suggested to start publishing interest rate forecasts after maturing the conditions so that CBRT can improve its credibility and possibility of success indirectly by improving its transparency. Another difference of communication strategies between the two central banks is distinguished as the press conferences that NB is doing but CBRT does not. For being a useful way of communicating with the public, press conferences are suggested to be used as a supplementary tool for CBRT. Only one difference is defined between the communication strategies of CBRT and NBP. Unlike CBRT, NBP newly started to publish voting results of MPC meetings. CBRT is suggested to apply this strategy in order to improve its transparency and therefore its credibility indirectly.

Having decided to implement inflation targeting regime, CBRT tried to take the steps to successfully implement the regime so far. Henceforward, CBRT should concentrate on improving its strategies and take the necessary steps concerted with this purpose.

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